Regarding the Application by Premera Blue Cross and its Affiliates to Convert to For-Profit Corporations

Washington State Office of the Insurance Commissioner
Docket No. G02-45

Supplemental Report
of

Aaron Katz

March 3, 2004

Background and Purpose

I have been retained as a consultant by Columbia Legal Services on behalf of four Interveners: The Premera Watch Coalition, the Washington State Hospital Association, the Washington State Medical Association, and the Alaska Blue Cross Conversion Task Force. I previously submitted two reports, created by a team I directed at the University of Washington Health Policy Analysis Program (HPAP), on the proposed Premera conversion on November 10, 2003. (I also provided deposition testimony explaining the opinions set forth in those reports.) The Interveners have asked me to supplement the opinions set forth in that report based on my review of confidential and "attorneys' eyes only" (AEO) versions of various reports by consultants to the Washington and Alaska insurance departments and consultants to Premera, as well as Premera's amended Form A and related exhibits. I have also reviewed certain OIC consultant supplemental reports concerning Premera's Amended Form A. Because I received these documents only a few days before I created this report, I have not had an opportunity to review them in as much detail as I would prefer, and thus I reserve the right to further refine the opinions set forth in this supplemental report based upon additional study of those materials.

My role as a consultant to the Interveners is separate from my previous role in directing the HPAP team whose study was commissioned by the Interveners and focused on the potential effects of Premera's initial proposed conversion on the markets in and residents of Washington and Alaska. The HPAP team produced two reports that summarized its findings.[1] These reports were based only on publicly available information.

The Interveners asked that I assess whether any of the additional information (i.e., confidential and "attorneys' eyes only" reports and revised Form A and related documents) would lead me to refine, supplement, or change the views set forth in the HPAP reports about the potential effects of a Premera conversion.

Methods

For this Supplemental Report, I reviewed the following conversion-related documents:

Attorneys' Eyes Only Versions of Premera Conversion Documents

The Blackstone Group. *Update Report on Valuation and Fairness of the Proposed Conversion.* February 27, 2004.

Cantilo & Bennett, L.L.P. *An Analysis of the Form A Statement Regarding the Acquisition of Control of a Domestic Health Carrier and a Domestic Insurer.* October 27, 2003.

Cantilo & Bennett, L.L.P. *Supplemental Report: An Analysis of the Form A Statement Regarding the Acquisition of Control of a Domestic Health Carrier and a Domestic Insurer.* February 27, 2004.

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[1] *Premera Conversion Study Report 1: Premera Involvement in Washington and Alaska Health Insurance Markets.* Health Policy Analysis Program, School of Public Health and Community Medicine, University of Washington. November 10, 2003. *Premera Conversion Study Report 2: Review of the Literature and Experiences of Other States, and Discussion of Potential Effects of a Premera Conversion.* Health Policy Analysis Program, School of Public Health and Community Medicine, University of Washington. November 10, 2003.

LeBoeuf, Lamb, Greene & MacRae, L.L.P. *Preliminary Report to the Alaska Division of Insurance, Proposed Premera Conversion.* October 20, 2003.

Leffler, K. *Antitrust Review by the Office of the Insurance Commissioner.* October 27, 2003.

Leffler, K. *Antitrust Review by the Office of the Insurance Commissioner: Supplement to the Report of Keith Leffler, Ph.D.* February 27, 2004.

Navigant Consulting. *Proposed Report on the Economic and Market Impact on Alaska of the Proposed Conversion of Premera Blue Cross to a For-Profit Entity.* September 23, 2003.

PriceWaterhouseCoopers. *Economic Impact Analysis of the Proposed Conversion of Premera Blue Cross for the State of Washington.* October 27, 2003.

PriceWaterhouseCoopers. *Economic Impact Analysis of the Proposed Conversion of Premera Blue Cross for the State of Washington: Report Addendum.* February 27, 2004.

PriceWaterhouseCoopers. *Exhibit 1: Report on Tax Matters in Connection with The Washington Foundation Shareholder and The Alaska Foundation Shareholder.* February 28, 2004.

Other Premera Conversion Documents

Amended Form A as filed on February 5, 2004.

Reid, EL. *In the Matter of the Application regarding the Conversion of Premera Blue Cross and its Affiliates.* November 10, 2003.

Comments on Original UW HPAP Reports

HPAP's Report 2 identified likely potential negative effects of the proposed conversion of Premera to an investor-owned, for-profit company:

- Reduced spending on medical care spending (lower medical loss ratio) and increased administrative expenditures (administrative cost ratio);
- Increased premiums;
- Reduced access and affordability, especially for low-income, rural, small group, and non-group populations and those with significant health care needs (e.g., people with disabilities) or who are disproportionately uninsured (e.g., people of color); and
- Reduced patient satisfaction, customer service, and attention to certain prevention measures, and increased complaints about administrative barriers and delayed care.

To a large extent, these concerns are based on the pressures of shareholders on a converted Premera to improve its bottom line. These pressures – driven by the fiduciary duty of a for-profit entity's executives to increase revenue for shareholders – add to those already in existence in the health care market to improve operating margins and avoid unprofitable lines of business. Shareholder expectations could be met by raising premiums, reducing covered or paid-for benefits, reducing payments to providers, reducing administrative costs, or improving the efficiency and efficacy by which care is provided (or some combination of these events). HPAP found little evidence of the latter two strategies in the experience of for-profit health plans, in

general, or of converted plans, specifically. HPAP did find evidence of first three types of strategies.

Report 2 also noted that 13 of 16 Blue Cross or Blue Shield health plans that have converted over the past 15 years are now owned by one of two national for-profit Blue Cross Blue Shield companies, Anthem and WellPoint. The Report therefore concludes that – despite claims made by Premera representatives – subsequent acquisition or merger of Premera is a reasonable possibility, which would accentuate the likely negative effects of conversions noted above. In addition, a non-local, for-profit Premera could be expected to engage in more contentious interactions with health care providers over contract and payment terms and to be less supportive of state health policy efforts to solve access and other issues.

My review of AEO versions of reports by consultants to the Washington and Alaska insurance departments and by Premera's consultants that were not previously available to me does not compel substantially different conclusions from those set forth in the HPAP reports. Indeed, much of the additional information simply provides more specific information – including estimates of potential premium increases, medical loss ratio increases, provider payment discounts in eastern Washington, and financial projections vis-à-vis likely shareholder expectations – that form the basis for concerns about access and affordability discussed in the HPAP reports.

In other words, much of the additional data help support the opinions already provided in the two HPAP reports.

I would note the following points for which I have gained additional insights from the supplemental material information, beyond those discussed in the HPAP reports:

- The Leffler report explains that the way that Premera now sets premiums for individual policies in Washington might reduce the likelihood that it would raise premiums where it has substantial market power, notably in eastern Washington.[2] Given shareholder expectations, I think this could then *increase* pressure on Premera to reduce payments to providers or to withdraw from unprofitable markets entirely, either of which could reduce access for state residents.
- The Leffler report also explains that, in Washington state, existing insurance regulations appear to limit the ability of Premera to increase premiums in the small group market, reducing the likelihood that it would raise premiums where it has substantial market power, notably in eastern Washington.[3] Again, given shareholder expectations, I think this could *increase* pressure on Premera to reduce payments to providers or to withdraw from unprofitable markets entirely, either of which could reduce access for state residents. Moreover, this pressure could cause Premera to lobby to change the regulations in order to enable Premera to have greater flexibility in setting premiums in the small group market.

[2] Leffler, K. *Antitrust Review by the Office of the Insurance Commissioner*. October 27, 2003.
[3] Leffler, K. *Antitrust Review by the Office of the Insurance Commissioner*. October 27, 2003.

- The LeBoeuf, Lamb, Greene & MacRae, L.L.P. report explains that health care providers appear to have considerable market clout in Alaska, thus reducing the likelihood that Premera could reduce provider payments there.[4] Given shareholder expectations, I think this could *increase* pressure on Premera to raise premiums or to withdraw from unprofitable markets entirely, either of which could reduce access for state residents.
- The LeBoeuf, Lamb, Greene & MacRae, L.L.P. report notes that changes in state premium (Alaska) and federal tax liabilities will put additional pressure on Premera to raise premiums, a pressure not included in the HPAP reports.[5]

Clarification of Certain Information in the HPAP Reports

Attorneys for Premera have raised some questions about the methods used to gather information for the HPAP reports. Specifically, they questioned the objectivity of the list of individuals and experts we interviewed.[6]

HPAP chose the types and numbers of individuals to interview to obtain a range of perspectives and views on the potential effects of a Premera conversion. HPAP did so cognizant of the limited time it had to conduct the study and the access it had to interviews conducted in other states. Specifically, HPAP had summary reports of extensive interviews conducted by consultants to the North Carolina Department of Insurance in the case of the proposed conversion of Blue Cross and Blue Shield of North Carolina. These interviews included: 9-12 interviewees in each of four case study states comprising insurance agents, regulators, consumer advocates, providers, and industry observers; 66 additional interviews with knowledgeable sources about North Carolina, including insurance agents, employers, patient advocates, physicians, hospitals, insurers, industry observers, and national experts.

HPAP decided not to duplicate these extensive interviews, but rather to focus its efforts on filling in gaps in the perspectives and expertise. Reliance on materials such as those identified in the HPAP reports is accepted practice in health policy analysis circles.

Comments on Amended Form A

Premera's revised Form A (and related Exhibits) made at least the following changes that are relevant to the potential effects of the conversion on the markets and residents of Washington and Alaska:[7]

- Stock options or grants to Premera board members or officers would now be prohibited in the first 12 months after conversion.[8] After this waiting period, Premera's board

[4] LeBoeuf, Lamb, Greene & MacRae, L.L.P. *Preliminary Report to the Alaska Division of Insurance, Proposed Premera Conversion*. October 20, 2003, p. 38.
[5] LeBoeuf, Lamb, Greene & MacRae, L.L.P. *Preliminary Report to the Alaska Division of Insurance, Proposed Premera Conversion*. October 20, 2003, p. 41.
[6] See *Premera Conversion Study Report 2: Review of the Literature and Experiences of Other States, and Discussion of Potential Effects of a Premera Conversion*. Health Policy Analysis Program, School of Public Health and Community Medicine, University of Washington. November 10, 2003, pp. 3-8.
[7] While Premera's Amended Form A contains numerous other changes, these are the ones that I focused on in arriving at my opinions.

members and officers would be eligible for significant financial incentives under a proposed plan. That plan, however, would only be in effect for two years, after which executive financial incentives would not be limited by any assurance or public oversight.

- Premera assures that, for two years after conversion, the converted health plan will continue pricing practices, broker commission schedules, and performance standards and incentives that do not distinguish between eastern and western Washington in the individual and small group markets.[9]
- Premera assures that, for two years after conversion, the converted health plan will continue to offer a network for a statewide PPO product in Washington.[10]
- Premera assures that, for two years after conversion, the converted health plan in Alaska will submit to appropriate regulatory rate review, not increase expense assumptions it used to develop its individual, small group, and large group rates, and not increase premiums as a result of changes in its tax liabilities due to conversion.[11]
- Premera assures that, for two years after conversion, the converted health plan in Alaska will continue to offer Blue Cross Blue Shield trademarked products on a statewide basis.[12]
- Premera assures that, for two years after conversion, the converted health plan in Alaska will continue to use statewide broker commission schedules for its individual and small group regulated products.[13]
- Premera assures that, for two years after conversion, the converted health plan in Alaska will use "reasonable" efforts to maintain provider networks.[14]
- The conversion will create two independent 501(c)(4) foundations, one each for Alaska and Washington.[15] Premera has drafted proposed articles of incorporation and bylaws that provide for the selection of the foundations' board members by the respective attorneys general of each state. Premera's proposal does not provide for any community advisory boards. Premera also proposes to restrict the foundations' grant-making or other activities by limiting the ability of the foundations and their grantees to lobby and conduct other activities that may be "materially adverse" to the interests and operation of health insurers in Washington or Alaska.

In general, Premera's assurances would only have the effect of postponing by two years (one year in the case of stock options as executive compensation), *but they would not eliminate or mitigate* the increased pressures from shareholder expectations that could lead to the negative

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[8] *Amended Form A*. February 5, 2004, p. 17.
[9] *Amended Form A, Exhibit E-8, Washington Economic Impact Assurances*. Section 1.4 (a) – (c).
[10] *Amended Form A, Exhibit E-8, Washington Economic Impact Assurances*. Section 2.2.
[11] *Amended Form A, Exhibit E-8, Alaska Economic Impact Assurances*. Section 1.4.1 – 1.1.5.
[12] *Amended Form A, Exhibit E-8, Alaska Economic Impact Assurances*. Section 2.1.1.
[13] *Amended Form A, Exhibit E-8, Alaska Economic Impact Assurances*. Section 2.1.4.
[14] *Amended Form A, Exhibit E-8, Alaska Economic Impact Assurances*. Section 3.3.
[15] *Statement Regarding the Acquisition of Control of a Domestic Health Carrier and a Domestic Insurer, Amended Form A*. February 5, 2004. Premera had previously proposed to create one 501(c)4 and two 501(c)3 organizations.

effects identified in the HPAP reports. In their supplemental reports, PriceWaterhouseCoopers[16] and Cantilo & Bennett[17] suggest that Premera's assurances should be effective for three years or more. Again, a longer period of assurance would postpone the potential negative effects, thus protecting state residents for a longer period, but it would not eliminate or mitigate the pressures that could lead to such effects in Washington and Alaska. In addition, the assurances do not appear to include any enforcement mechanisms. I reserve the right to consider this issue further should additional information be provided.

Various of the draft consultant reports, submitted in October 2003, for the two insurance departments noted that Premera's own financial projections show [ ] levels of profitability after conversion than shareholders might expect.[18] Apparently, more recent data show [ ] rates of growth in expenses and operating income,[19] but [ ] growth in enrollment and revenues.[20] The pressure to meet higher levels of profitability could lead Premera to change how it sets individual rates in Washington in order to differentiate eastern and western Washington markets or how it sets premiums in Alaska. Such pressure could also lead Premera to lobby state policy makers to change regulatory constraints on geography-specific small group rate-setting. The assurances in Exhibit E-8 do not dispense with these concerns or the impacts on cost and access that could result.

Proprietary Material
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Comments on the Proposed Foundations

The report of E. Lewis Reid[21] is primarily directed at the proposed creation of the Foundation Shareholder (now two Foundation Shareholders, one for each state, as described in revised Form A) and the potential benefits of the resulting charitable mission and activities. This report argues that these two charitable organizations would result in a "burst of health philanthropy" to address issues of the uninsured, health status of minorities, community mental health funding, and the effects of rising costs on access in rural communities.

My analysis of the potential philanthropic benefits of the proposed foundations is that they will either be short-lived (if the level of charitable spending is high) or small (if charitable spending is sustained) relative to the significant problems of the health care systems in Washington and Alaska, which the proposed conversion itself will likely exacerbate.

[16] PriceWaterhouseCoopers. *Economic Impact Analysis of the Proposed Conversion of Premera Blue Cross for the State of Washington: Report Addendum.* February 27, 2004, pp. 4 and 5.
[17] Cantilo & Bennett, L.L.P. *Supplemental Report: An Analysis of the Form A Statement Regarding the Acquisition of Control of a Domestic Health Carrier and a Domestic Insurer.* February 27, 2004, transmittal letter p. 9.
[18] See, for example, LeBoeuf, Lamb, Greene & MacRae, L.L.P. *Preliminary Report to the Alaska Division of Insurance, Proposed Premera Conversion.* October 20, 2003, pp. 36, 47.
[19] PriceWaterhouseCoopers. *Economic Impact Analysis of the Proposed Conversion of Premera Blue Cross for the State of Washington: Report Addendum.* February 27, 2004, p. 4.
[20] PriceWaterhouseCoopers. *Economic Impact Analysis of the Proposed Conversion of Premera Blue Cross for the State of Washington: Report Addendum.* February 27, 2004, p. 3.
[21] Reid, EL. *In the Matter of the Application regarding the Conversion of Premera Blue Cross and its Affiliates.* November 10, 2003.

The Reid report suggests that the combined assets of the Washington and Alaska foundations might be $500-600 million.[22] That is certainly a lot of money, but the impact this new resource is likely to have is considerably less than the Reid report implies. The reason has to do with the actual level of charitable giving or program activity that is likely to accrue in any given year.

One possibility is that the foundations will maximize their impact in the short run by making grants and carrying out programs that spend the corpus in, say, five to 10 years. Benefits will presumably accrue for the residents of Alaska and Washington from $50 - 100 million per year in philanthropic spending, but such benefits will essentially end when the funds run out, whereas any negative effects of the conversion will continue on into the future.

On the other hand, many charitable foundations in the health sector do not spend out their entire endowment in a few years. Rather, in order to be active in their respective arenas over a long period of time, their boards limit the amount of annual outflow. Spending the equivalent of about 5% of the endowment is, in my understanding, fairly typical (and the required minimum payout for 501(c)3 foundations[23]). So, if the combined activity of the Alaska and Washington foundations is consistent with this typical behavior, they might engage in charitable activities of around $25-30 million per year. How much influence might $30 million, or even $100 million, have in addressing the critical health policy issues noted in the Reid report? To develop some perspective on this question, we might look from two perspectives.

First, the issues the Reid report suggest could be addressed by the foundations and the statements of purpose in the Plan of Distribution of Premera define a scope as broad as the health care system itself. How does the likely annual charitable output compare with the size of that system? The most recent official estimate of total annual personal health care spending in Washington state is about $19 billion and in Alaska $2.1 billion for 1998.[24] Using a conservative annual inflator of 5% for illustration purposes, these totals for 2004 would be $25.5 billion and $2.8 billion, respectively, or a combined total of $28.3 billion. An outflow of the charitable foundations of $30 million would be equal to about 0.11% of total health care spending in the two states; $100 million in annual philanthropy would be equal to about 0.35% of total health care spending. Expectations about the benefits from conversion foundation activities must be commensurate with the *relative* size of this likely level of charitable spending.

Perhaps an even more pertinent analysis would be to weigh the potential benefit of $30 million or $100 million in charitable activities against the potential negative effects as identified in the HPAP reports. One somewhat quantifiable effect is the potential increase in premiums and the effect such increases might have on the number of uninsured residents. Estimates of how many people would not be insured as a result of a premium increase vary in the literature. A recent article suggests that there is some consensus that a 1% increase in premiums would reduce demand for insurance by 0.4 - 0.6%.[25] Demand does not equal "take up," however; that is, some

[22] Reid, EL. *In the Matter of the Application regarding the Conversion of Premera Blue Cross and its Affiliates.* November 10, 2003, p. 3.
[23] It is my understanding that no minimum spending requirement exists for 501(c)4 organizations such as those that Premera proposes to create.
[24] Kaiser Family Foundation. *State Health Facts Online.* http://www.statehealthfacts.org.
[25] Glied, S, DK Remler, and JG Zivin. Inside the Sausage Factory: Improving Estimates of the Effects of Health Insurance Expansion Proposals. *The Milbank Quarterly.* Vol. 80, No. 4, 2002.

people who seek coverage do not end up actually obtaining coverage. Take up varies considerably by income and circumstance (e.g., individual coverage, employer-sponsored coverage, public programs). If we use a reasonable figure for take up, such as 85%,[26] then a 1% increase in premiums might reduce the actual number of insured people by 0.34 – 0.51%.

Consultants to the two state insurance departments have suggested that, for various reasons, a post-conversion Premera might need to increase premiums by as much as 10% in individual and small group markets in eastern Washington[27] and 5.5% in Alaska.[28] If we use these premium increases with the lower end of the range above (0.34), and apply them to the relevant Premera markets, we get the following estimates:

	Number of Insured People Potentially Affected	Percent Increase in Uninsured per 1% Premium Increase	Estimated Premium Increase	Total Number of Additional Uninsured Individuals
Washington	88,600[29]	0.34%	8-10%	2,409-3,012
Alaska	113,000[30]	0.34%	5.5%	2,113

What is the monetary value of these additional uninsured individuals? For purposes of illustration, we could use average annual premiums for Premera enrollees that, according to Navigant Consulting,[31] were $[ ] in 2002 in Washington and $[ ] in Alaska. Using the same 5% annual inflation rate as I used above and applying the additional premium increases noted in the table only to the 2004 premiums, these figures in 2004 would be $[ ] and $[ ] respectively. Thus, if the foundations were simply to purchase health insurance coverage for the newly uninsured, the costs in each state would be:

Washington $[ ] million
Alaska $[ ] million

Proprietary Material
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Thus, the typical amount of charitable activity of the two proposed foundations would leave perhaps $[ ] million per year over and above that needed to just redress one of the problems caused by the conversion itself. This very rough comparison does not take into account the possibility that Premera might increase premiums to additional groups of its policy holders, that

[26] Take-up rates for wage and salary workers declined from about 90% in 1988 to just more than 80% in 2001, see Fronstin, P. Trends in Heath Insurance Coverage: A Look at Early 2001 Data. *Health Affairs*. Vol. 21, No. 1. January/February 2002, p. 189.

[27] PriceWaterhouseCoopers. *Economic Impact Analysis of the Proposed Conversion of Premera Blue Cross for the State of Washington*. October 27, 2003, p. 122.

[28] LeBoeuf, Lamb, Greene & MacRae, L.L.P. *Preliminary Report to the Alaska Division of Insurance, Proposed Premera Conversion*. October 20, 2003., pp. 49.

[29] PriceWaterhouseCoopers. *Economic Impact Analysis of the Proposed Conversion of Premera Blue Cross for the State of Washington*. October 27, 2003, p. 37. Calculated from Table 5-5 using market shares for individual and small group markets in eastern Washington.

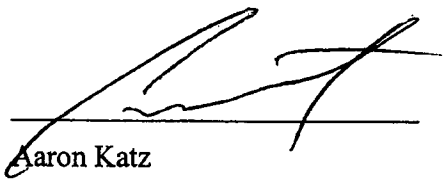
[30] Navigant Consulting. *Proposed Report on the Economic and Market Impact on Alaska of the Proposed Conversion of Premera Blue Cross to a For-Profit Entity*. September 23, 2003. Calculated from information on pp. 25 and 33.

[31] Navigant Consulting. *Proposed Report on the Economic and Market Impact on Alaska of the Proposed Conversion of Premera Blue Cross to a For-Profit Entity*. September 23, 2003, p. 53.

other insurers in these markets might also raise premiums, or that other negative impacts identified in the HPAP reports might occur (e.g., Premera exits unprofitable markets), thus increasing the number of uninsured even more. Moreover, this rough comparison does not take into account the many other problems noted by the Reid report that need attention and whose solutions would cost considerably more than the likely level of charitable spending of the two foundations.

One other aspect of the proposed foundations appears likely to affect their benefits to the residents of the two states. The Plan of Distribution (as well as other documents) iterates the mission and purposes of the foundations. Generally, the stated use of the funds appears quite beneficial, including such priorities as improving health education, quality of care, and access to care. The Plan, however, appears to prohibit the use by the foundations of the conversion assets for any activity that "likely would result" in negative effects on any health insurer.[32] Thus, even if the foundation boards' determined that, for example, tighter insurance regulations were essential to fulfilling the foundations' mission to improve access, it would be prohibited from using the conversion assets to work for such changes. Since much attention has, and will be, placed on the health insurance market as a key factor in, if not cause of, many access barriers, this clause seems quite limiting concerning the potential benefits for state residents.

In my view, the potential activities of the proposed foundations do not offset the potential negative impacts of conversion on the health care markets and residents of Alaska and Washington.



Aaron Katz

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Date

[32] *Plan of Distribution, Amended Form A*, Section 1(c)iii.